SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
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"OVERSIGHT OF THE FEDERAL HOME LOAN BANK SYSTEM"
SEPTEMBER 9, 2003

Chairman Bennett, Senator Johnson, members of the Subcommittee. It is a pleasure to appear before you today to assist you in your oversight of the Federal Home Loan Bank system. A strong housing market is among the Nation's top economic priorities, and the Federal Home Loan Bank System is an indispensable component of that market. When the Hoover Administration developed the blueprint for the system in the throes of the Great Depression, it was based on the premise that this cooperative was needed to assure a constant flow of funding when deposits proved inadequate due to national or regional economic conditions. Seventy years later, with over $500 billion in FHLB advances outstanding, the underlying premise for the System remains valid. The Federal Home Loan Banks play a vital role in mortgage finance and deserve to be continued and strengthened.

Challenges Confronting the System

It is in the spirit of System supporter that I come to you this morning to raise three issues that I believe warrant your attention: multi-district membership, expansion of the System's mortgage acquisition programs, and lack of SEC registration of FHLB securities. These issues are important because their resolution will help determine the future of the system and its long-term stability. They were examined in detail in a paper I recently completed that was funded by a grant to the School of Management from the Fannie Mae Corporation, which I would like to submit for the record. The conclusions reached in the paper are my own, and do not reflect the views of the research sponsor. After discussing my paper, I will make some general observations about the FHLB system's regulatory structure in relation to efforts underway to improve safety and soundness regulation of Fannie Mae and Freddie Mac.

Multi-District Membership

Recent industry consolidations have prompted some to call for allowing members to belong to more than one district FHLBank. Throughout the System's history, no single institution has ever been a member of more than one district bank and the System's authorizing statute leaves little doubt that this is what Congress intended. The Federal Housing Finance Board's (FHFB) efforts to allow multi-district membership by regulation have been highly controversial, supported by only five of the System's twelve district banks. Four of the FHLBanks are strongly opposed, with the remaining three undecided and expressing serious reservations.

My primary objection to multi-district membership is that Congress – not the FHFB – should decide whether such a fundamental change should be made to the System's historic regional and cooperative structure. I am also concerned that multi-district membership could have a destabilizing influence on the System. Multi-district membership would allow large institutions to "shop" their advance activity among multiple FHLBanks, but because all the FHLBanks raise funds in the same way, their ability to compete based on price will be limited. As a consequence, they will likely compete on collateral and credit standards. In addition to diminution of credit quality, allowing one member to have multiple relationships with FHLBanks would increase operational risk since the System lacks safeguards to obviate the multiple pledging of collateral or the prospect of competing blanket liens. Moreover, allowing multiple memberships could increase large borrower activity in the system as a whole, thus exacerbating large borrower concentrations. Nearly 24% of all advance activity is already concentrated in the System's 10 top borrowers.

Multi-district membership would, by definition, help only institutions large enough to take advantage of it, and fundamentally alter the basic concept of the System – a cooperative of regional banks existing to serve the funding needs of institutions headquartered in their districts. Moreover, given the seismic consolidation activity that occurred in the 1980's – which the System weathered quite well – it is difficult to see why current consolidation activity should provide the impetus for such a dramatic restructuring. Under a holding company structure, separately chartered subsidiaries have been able to hold memberships in different banks -- the same arrangement commercial banks have with the Federal Reserve banks – which maintains consistency with the Federal Home Loan Bank Act and the regional character of the System.

The Mortgage Acquisition Programs

The second issue I examined – expansion of the System's mortgage acquisition programs – also primarily benefits the System's largest members. Begun in 1997 as a small pilot capped at $750 million, these programs have grown exponentially. The System now holds $90 billion worth of mortgages in portfolio, representing over 10% of its assets. One FHLBank now has half its assets invested in mortgages and only one-third of its assets in advances, the business activity that Congress assigned it.

There is nothing in the System's legislative history or authorizing statute that grants authority for direct mortgage purchases, and the other two major housing GSEs, i.e., Fannie Mae and Freddie Mac were established and chartered by Congress expressly for that purpose. Congress, not the individual FHLBanks or the FHFB, should decide whether it wants the System to be a major player in the secondary mortgage market, and if so, the terms and limitations that should apply.[1]

The risks associated with mortgage acquisition are distinctly different from those associated with the System's traditional role of making fully collateralized advances. Advances have prepayment penalties and call features that allow the FHLBanks to effectively manage their interest rate risks. Different, more complex tools are needed for the interest rate/prepayment risk presented by mortgages held in portfolio. Operational risk is also significant – there is a serious question as to whether the System has sufficient numbers of qualified staff or infrastructure needed to manage even the day-to-day risk associated with secondary mortgage market participation. The staffs of each FHLBank and the Office of Finance are relatively small, and they are trained in the traditional business of advances, not mortgage acquisition and portfolio management. Regarding credit risk, the mortgage acquisition programs' proponents boast that the originators – not the FHLBanks – retain the credit risk. In truth, the originators provide credit enhancements that are only as good as the FHLBanks require them to be based on their own interpretation of historical default data, which again, is outside their traditional mission and expertise. It is also telling that a recent FHFB proposed rulemaking – now withdrawn – would have eliminated one of these programs most important tools in managing credit risk – the requirement that pools of purchased mortgage assets achieve an investment grade rating from an independent ratings agency.

No adequate public policy basis has been advanced for the System's foray into this new, riskier line of business. Though promotional materials for the programs claim that they are designed to help smaller institutions, available data suggests that they are being run overwhelmingly for the benefit of large originators. According to trade journal reports, the top five mortgage originators sold $42.7 billion in mortgages to the FHLBanks in 2002.[2] Assuming the accuracy of this report, these five institutions would account for almost all of the $45.7 billion dollars in FHLBank mortgage acquisitions in 2002. If Congress wishes to authorize yet another GSE entry into the secondary mortgage market, it should assure itself there is a valid public policy basis to do so. Meeting legitimate market needs of smaller, community-based institutions might be one justification. Enriching large mortgage originators is not.

SEC Registration

In my paper, I also concluded that voluntary SEC registration would be in the best interests of the System and its debt holders. I will not belabor the arguments, because Assistant Secretary Abernathy has already eloquently stated them in his testimony. Suffice it to say, voluntary SEC registration would enhance the image of the system and demonstrate that the FHLBanks are committed to a policy of full disclosure.

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[1] Congress placed specific limitations on Fannie Mae and Freddie Mac regarding capital, safety and soundness, and mission requirements. However, since Congress never authorized the FHLB System to enter the secondary mortgage market, it did not specify the limitations that should apply.

[2] Inside the GSEs (April 2, 2003), at p. 6; 2002 FHLBank System Annual Report at p. 22.

Thoughts on Regulatory Structure

Questions about the capability of the System to manage new risks associated with multi-district membership and mortgage acquisition programs are heightened by longstanding weaknesses in the FHFB examination process, identified by the Government Accounting Office (GAO) in 1998 and again in 2002. Though the FHFB has taken a number of steps to address these weaknesses, including increasing the number of examiners and putting greater focus on major risks and the quality of controls at FHLBanks, the GAO found in a report released last February that it is still too soon to evaluate the effectiveness of these measures. As of February 2003, the FHFB had only 14 examiners, with plans to increase the total number of examiners to 24 by the end of 2004. According to its FY 2003 budget, only $9.7 million of its $27 million budget was allocated for the Office of Supervision. By way of comparison, Treasury's two bank regulatory bureaus – the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) will typically assign teams of 20 –30 examiners to *each* of its largest institutions, and will spend 70-80% of their budgets in direct support of supervision.

More fundamentally, the structure of the FHFB suffers from many of the same defects now being scrutinized at the Office of Federal Housing Enterprise Oversight. It is a small, low profile agency that simply cannot attract and retain the quality of staff that it needs. It exists outside the financial regulatory mainstream, and thus does not benefit from the, routine day-to-day interaction that occurs among the major bank regulatory agencies. It is responsible for only 12 banks, plus the Office of Finance – a narrow constituent base that creates the perception of "captive regulator." Other major financial regulators have a much broader regulatory base, and their actions are generally reflective of the views and interests of diverse and competing constituencies. For instance, bank regulators are constantly mediating differences between large and small banks, those with different business lines, geographic concentrations, or customer bases. This in turn enhances the credibility and quality of regulatory decision-making. When a regulator's jurisdiction is confined to a small group of closely aligned institutions, the pressure and input it receives can become narrowly focused and one-sided. It becomes difficult for the regulator to stay objective and "above the fray."

Should a new agency be created at the Treasury Department for oversight of Fannie Mae and Freddie Mac, I believe it would be a stronger agency if it also included oversight of the FHLB System. The new regulator would have a bigger, better view of the housing finance market and would be in a better position to evaluate the advantages – and dangers – of the major housing GSEs competing directly with each other in the same lines of business. From the standpoint of systemic risk and taxpayer exposure, it's just as important to the government for the FHLB System to have quality safety and soundness oversight as it is for Fannie and Freddie. At year-end 2002, the System had $668 billion in outstanding debt, compared to Fannie's $884 billion and Freddie's $644 billion. It enjoys the same implied government guarantee, with an even more generous line of credit from the US Treasury. Though unlikely, a widespread failure in the System could have staggering ramifications for US taxpayers and the housing market.

Some have argued that the FHLBanks would be overwhelmed by the other two politically powerful GSEs if their oversight were to be housed in the same agency. I don't believe it. With their longstanding community bank ties, and extensive grass roots, I have no doubt the FHLBanks can hold their own. I have also heard it argued that the Treasury Department would be hostile to the System, which I can say from first hand experience is not the case. On the contrary, I believe the Treasury respects the role of the System in the housing finance market and would not do anything to disrupt it.

The competitive impact on FHLB funding costs should also be weighed in the balance when considering whether to merge the FHFB into the new agency. The creation of a credible, high quality GSE regulator within the Treasury will likely receive a positive reaction in the capital markets, which could reduce Fannie and Freddie's funding costs. If the FHLB System is left out, that could widen spreads between FHLBank securities and those issued by the Enterprises. Wider spreads would in turn mean a higher cost of funds for the FHLBanks, which would adversely impact the price of advances and other FHLBank services.

Conclusion

Strong momentum is building for the creation of a credible, high quality regulator within the Treasury Department to replace OFHEO. Now would be a propitious time for the Congress to consider whether oversight of the FHLB system should also be placed under this new regulator. To be sure there are important policy determinations that Congress needs to make regarding the FHLB System's mission and future, and it is important not to impede the momentum behind the transfer of OFHEO's safety and soundness functions. However, concurrent action could assure quality regulation of all three major housing GSEs, and prevent a widening of spreads, which could further weaken the System.

Thank you Mr. Chairman. I will now be happy to answer any questions you may have.

IS THE FEDERAL HOME LOAN BANK SYSTEM FORSAKING ITS ROOTS?

Sheila C. Bair

June 2003

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Introduction

Growing up in rural southeast Kansas, my first impressions of the Federal Home Loan Bank System were formed by those of my parents and their depression-era contemporaries. Living through the Great Depression, they remembered the System's role in helping cash-strapped savings and loans stay afloat, and thousands of families stay in their homes.

Moreover, in the pre-branching era of my youth, the thrift institutions serving rural communities in Kansas and elsewhere, were, for the most part, independently owned, community-based institutions, which relied on the System as a vital source of funding through the cyclical ebbs and flows of deposits. The Federal Home Loan Bank System was viewed as a stable, respected American institution, one of the keys to rural America's survival through the depression, and an important source of funding for mortgage lending to facilitate achievement of that quintessential American dream, home ownership.

So it is that with those early impressions, I have retained a favorable bias toward the System in its role as a regionalized funding source for smaller, community-based lenders, though I concede the importance—up to a point—of its support for larger lenders as well. Perhaps it is because of that bias, and nostalgic fondness, that I feel compelled now to raise the alarm over a trend that I find disturbing: the transition of the System into a centralized provider of funds and services for large mortgage originators. And, if current trends continue, it could become a major player in the business of purchasing and securitizing home mortgages—a line of work much riskier than the System's traditional job of making heavily collateralized loans, and less responsive to the needs of small community lenders. Such a transformation poses safety and soundness risks to the FHLB System.

These changes are not sanctioned by the FHLB System's authorizing statute and legislative history. In addition, no compelling public policy rationale has been proffered to justify this new, expanded use of the System's status as a government-sponsored enterprise (GSE).

When Congress last acted on the Bank System in the Gramm-Leach-Bliley Act of 1999, the only major new power granted was targeted at smaller members: a directive to the FHLBanks to use their GSE-favored status to support additional forms of lending by community banking institutions. Congress didn't see fit to shift the emphasis toward the needs of larger institutions nor grant the System the right to enter the complex, higher-risk secondary mortgage market. There are two other established GSEs created expressly for the latter purpose, with capital and ownership structures tailored to that mission.

Congress also decreed that a financial institution may belong only to one FHLBank. The recent attempts at the regulatory level to allow multiple memberships would introduce a potentially revolutionary change to the System—a change that is at war with its 70-year history as a cooperative, is legally unsound, and has not been the subject of either public or Congressional review.

If the FHLBanks and their regulator want to transform themselves, they should ask Congress for that authority, and present rigorous analysis of both the supposed benefits to be gained by such an expansion *and* the potential costs, including increased risks to the federal government (both the Treasury and the FDIC).

Could such a case be made? It is my hope that this paper will help facilitate vigorous public debate on that question. I am sure that proponents of multi-district membership and mortgage securitization authority will be unhappy about some of the arguments I make. I have meant to be provocative, because I think all who depend on the Bank System need to think harder about where it is headed.

If centralization and securitization can be justified based on sound public policy and rigorous cost benefit analysis, then there is no reason why their advocates shouldn't go to Congress, make the case, and secure clear statutory approval. If such a case cannot be made, however, the System's leadership should not allow such fundamental changes to take place outside of what Congress and the law have authorized.

History of the Federal Home Loan Bank System

"The benefits of FHLB membership are vitally important to community banks and their ability to serve their customers."

Independent Community Bankers of America[3]

"ACB strongly supports the cooperatively based FHLBank System with a primary mission of providing community banks with access to advances for housing and community development lending."

America's Community Bankers[4]

"There are numerous forces at work that may drive the System to consolidation into a single, massive and very powerful government-sponsored enterprise, one that is engaged in a business and serving a function very different from the business and function it has historically performed, and more like those performed by the other two housing GSEs. By eliminating local control of the FHLBanks and undermining the regional nature of the System, it seems likely that such consolidation would reduce the System's responsiveness to the needs and priorities of local businesses and communities."

2002 Annual Report
San Francisco Home Loan Bank

The Federal Home Loan Bank System was created by the Federal Home Loan Bank Act of 1932.[5] It was the result of a proposal unveiled by President Herbert Hoover in 1931 as part of a package of economic reforms to respond to the financial crises created by the Great Depression and, in particular, to provide relief to economically distressed savings and loans,[6] and the urban and rural home owners who relied upon them for mortgage loans. Hoover's memoirs make clear that he intended the System to make mortgage money more available in good times and bad, assuring a constant flow of funding when deposits dwindled due to national or regional economic conditions.[7]

Hoover's proposal was controversial, opposed by commercial banks and insurance companies, and viewed with trepidation by fiscally conscious legislators concerned about the government's potential exposure to System losses. The bill took seven months to

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3 *ICBA's 2003 Policy Resolution on the Federal Home Loan Bank System*, available at http://www.icba.org/ /news_views/news_views_fr.html
4 *2003 Policy Position on the Federal Home Loan Bank System*, available at http://www.acbankers.org /government/03PolicyBook.pdf
5 12 U.S.C 1421, et.
6 Or *building and loans* as they were then called.
7 The Memoirs of Herbert Hoover, 1929-41 The Great Depression (MacMillan 1952) at 111-115.

enact—slow by standards of the day—but the fundamental design that was adopted has remained for over 70 years.

The System Matures

The 1932 legislation authorized the creation of eight to twelve Banks, and established the Federal Home Loan Bank Board (FHLBB) to oversee the Banks. The purpose of the FHLBanks was to lend money to building associations, savings banks, and similar institutions primarily engaged in the business of making loans to homebuyers. The System was designed to require the Banks to over-collateralize the loans they made through the assignment of mortgages held by the borrowing institution, and to further secure them by a lien on the borrowers' capital stock.[8]

As originally enacted in 1932, the FHLBank Act temporarily authorized the FHLBanks to act as home mortgage lenders of last resort.[9] Significantly, Congress repealed this authority eleven months later, on June 13, 1933.[10] Instead, the Reconstruction Finance Corporation chartered the Federal National Mortgage Association (Fannie Mae) in 1938 to buy FHA-insured mortgages. By 1939, Fannie Mae had purchased 26,726 mortgages, aggregating more than $100 million.[11]

During the first 40 years of its existence, the Federal Home Loan Bank System matured and—with some tinkering from Congress—became an established, stable source of continual funding to support the thrift industry in making mortgage loans. In 1970 the thrift industry persuaded Congress to create a government-sponsored thrift-oriented equivalent to Fannie Mae to further support the secondary market for home mortgages.[12]

The stock of the new corporation, called the Federal Home Loan Mortgage Corporation or Freddie Mac, was owned by the FHLBanks (and, therefore, indirectly by their thrift members), and its Board was composed of the same officials who made up the FHLBB.

Thus, instead of authorizing the FHLBanks to conduct secondary market operations, Congress established a distinct, specialized corporation within the System to perform those functions. (Eventually, in 1989, investment in Freddie Mac was opened up to the general investing public and an independent, shareholder controlled Board of Directors was established.)

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[8] "New Federal Organization" (The Brookings Institution 1934) at pp 40 – 42. Over-collateralization has remained a mainstay of the FHLB System throughout its history, and the chief reason why the System can boast that its district Banks have never suffered a credit loss.

[9] Section 4(d) of the FHLBank Act of 1932. A "sunset provision" in the 1932 statute would have terminated the mortgage lending authority once the FHLBanks were fully capitalized by their members.

[10] Home Owners Loan Act, ch. 63 §3 (1933). The 1933 repeal came before the sunset date set in the 1932 legislation.

[11] Jones, "Fifty Billion Dollars" (MacMillan 1951) at pp 149-152. See also, Stanton, "A State of Risk" (Harper Collins 1991) at pp 21-22.

[12] Congress had denied retail lending power to the FHLBanks in 1969, when it rejected a provision in a bill that would have permitted the FHLBanks "to purchase, service, sell, or otherwise deal in" residential mortgages. *See* H. Rep. No. 15091 (to accompany S. 2577), Dec. 1969.

Surviving the Thrift Crisis

The thrift industry's return on assets reached a peak in 1978. Then it was hit by two successive crises. The first was caused by the soaring interest rates of the late 1970s and early 1980s. The thrift model involved making long-term, fixed-rate mortgages funded by short-term deposits. This model proved highly profitable in the post-war period characterized, as it was, by relatively stable interest rates. But when interest rates climbed to unprecedented heights beginning in the late 1970s, thrifts were squeezed between the higher rates of interest they were paying on their deposits and the much lower rates they were receiving on their long-term mortgages. Virtually the entire industry started losing money and many institutions failed.

Both the federal government and, more particularly, several of the states tried to rescue the ailing industry by authorizing new powers for thrifts. With weak supervision over the industry, many hundreds of thrifts misused their new powers, gambling on high risk loans and investments, and causing the second thrift crisis—which lead to an eventual $150 billion cleanup bill for taxpayers. Other thrifts, however, continued with their traditional home-lending orientation. These institutions recovered when interest rates declined and they constitute the healthy thrift industry that remains to this day.

Notable in this maelstrom was the resiliency of the Bank System. Membership was almost halved, falling from 4,250 in 1979 to 2,337 in 1992. Similarly, the loans FHLBanks make to members (called "advances") fell by 48% between 1988 and 1992—from $153 to $80 billion. But the System proved to be remarkably flexible and it is telling that it survived, like the now-healthy part of the thrift industry, because most of the FHLBanks stuck~~byicking~~ to their~~its~~ traditional business of making advances to members secured by mortgage loans. In spite of the turmoil in the industry of which it was an integral part, the FHLBanks didn't suffer a single credit loss.

In addition, by opening membership to banks and credit unions, Congress was able to restore a stronger business footing for the System. In fact, the FHLBanks made a net contribution to the cleanup of problem thrifts when Congress redirected over $3 billion from the retained earnings of the Banks and a continuing annual assessment of over $300 million to help defray some of the cost of dealing with so many failed institutions.

Gramm-Leach-Bliley Act

In 1999, the Gramm-Leach-Bliley Financial Services Modernization Act[13] (GLBA) made further changes in the System's structure. These changes addressed growing problems with the capital base of the FHLBanks and re-emphasized congressional support for the System's mission to serve community-banking institutions.

Existing rules allowed any member, except a federally chartered thrift, to exit the System with six months' notice, redeeming its investment in FHLBank stock when it left.

[13] Pub. L. No. 102, 113 Stat. 1338 (1999)

~~Federally chartered thrifts provided the only stable source of capital because of the fact that they, and only they, were enjoined from leaving.~~ As membership in the System broadened, this unequal approach was difficult to sustain.

Congress solved the dilemma with an elegantly simple solution. It made membership voluntary for all but provided for stability of the System's capital base by allowing the FHLBanks to capitalize themselves with stock that couldn't be withdrawn for five years.

As part of the capital restructuring, GLBA also directed the System's~~new~~ regulator—the Federal Housing Finance Board (FHFB)[14]—to implement new capital rules addressing leverage and risk-based capital requirements, and directed each FHLBank to submit a capital plan to the FHFB for approval. These rules, which were finalized by the FHFB on January 30, 2001, provide for a new, two-part capital adequacy test: an effective equity capital to assets leverage ratio of 4% and the imposition of risk-based capital requirements. The FHFB has now approved new capital plans for all twelve Banks, which have three years to implement the plans. Four of the twelve Banks have implemented their plans to date.[15]

Finally, Congress expanded membership to include "community financial institutions" defined as banks, thrifts, or credit unions with assets of less than $500 million (indexed for inflation), even if less than 10% of their assets were in mortgages. The GLBA also made small business, small farm, and small agri-business loans eligible collateral for FHLBank advances for members having less than $500 million in assets.

The Current FHLB System

The FHLBank System's business has grown significantly from its low level in 1992. Its membership has more than tripled and advances, its main business line, have sextupled. The number of members has grown from 2,337 in 1992 to 8,011 at the end of 2002. Advances to member institutions—its historic, core activity—have dramatically increased from $80 billion in 1992 to $490 billion outstanding at year-end 2002. These advances are collateralized primarily through mortgage loans and further supported by a borrowers' capital stock.

As advances fell drastically in the early 1990s, the FHLBanks changed the composition of their balance sheets by markedly increasing their portfolio of non-advance investments. As the level of advances began to recover, however, the FHLBanks continued to maintain a high percentage of non-advance investments. This enabled the Banks to leverage their capital and earn a higher level of return on it. In the late 1990's, the System's continued maintenance of significant non-advance investment activity drew

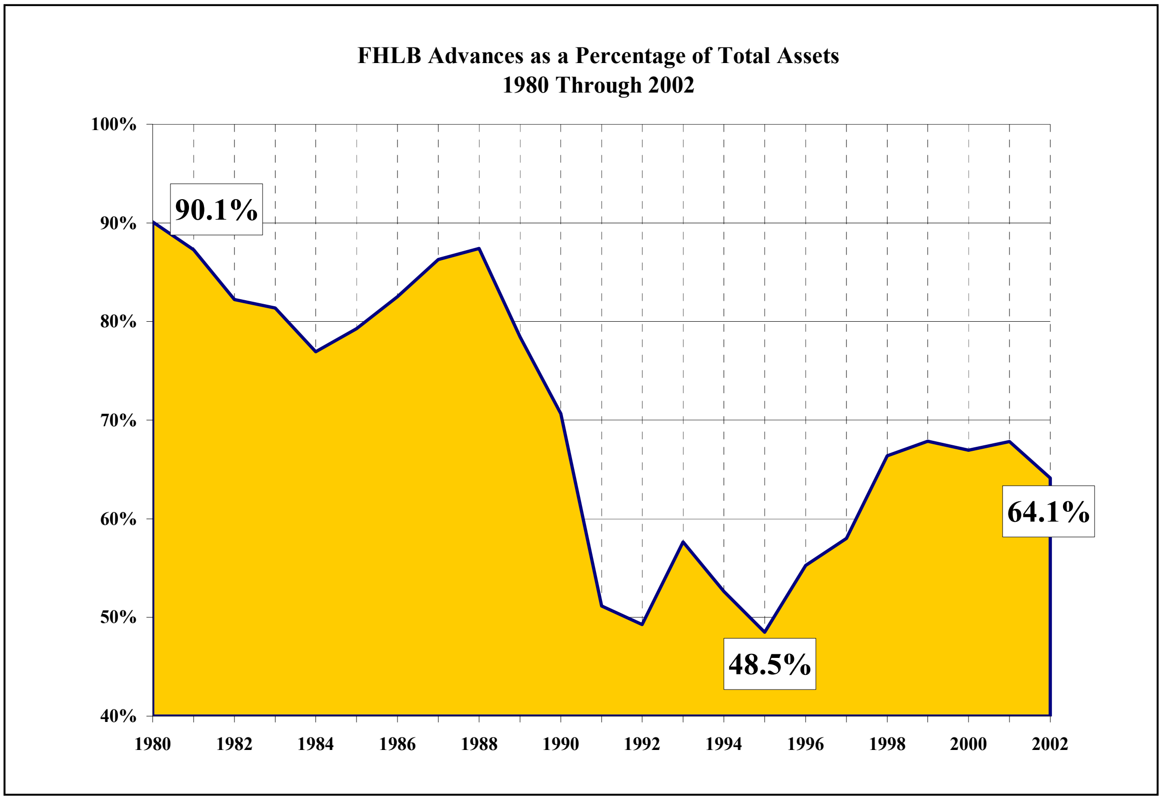
[14] In 1989, Congress dismantled the Federal Home Loan Bank Board, concluding that it had grown too close to the industry it was charged with regulating. The Board's functions as principal regulator of federally chartered thrifts were moved to a new agency, the Office of Thrift Supervision (OTS), created as a bureau of the Treasury Department, a sister agency to the Office of the Comptroller of the Currency (OCC) which regulated federally chartered commercial banks. A new, independent regulatory agency, the Federal Housing Finance Board, was created to oversee the Federal Home Loan Banks.

[15] These four Banks are: Seattle, Pittsburgh, Cincinnati and Indianapolis. 2002 Annual Report, at 6.

fire from the Treasury Department. As the Department stated in testimony before the House Subcommittee on Capital Markets on September 24, 1998:

> "Since government sponsorship permits the FHLBanks to borrow at subsidized rates, most of their investments constitute an arbitrage of credit flows in the capital markets—borrowing funds in the capital markets at below-market rates and investing them in securities at market rates. … We believe that the FHLBanks' large investment portfolios violate the spirit and arguably the letter of the FHLBanks Act.[16]

As the balance sheet of the System has changed, the percentage of the System's balance sheet made up of advances has declined significantly. In 1980, prior to the unfolding of the S&L crisis, outstanding advances represented 90% of total assets. But by 1990~~2~~, that percentage had declined to 64% and has ranged from 48.5% to 68% over the past decade.



As shown in the following chart, non-advance investments had been declining as a percentage of total assets from 1995 until 1999, when the first mortgage purchase program approved by the FHFB began to grow. In fact, the FHFB expressly limited each FHLBank's MBS investments to 300% of its previous month's capital. That limitation, however, did not apply to the new mortgage purchase programs: the Mortgage

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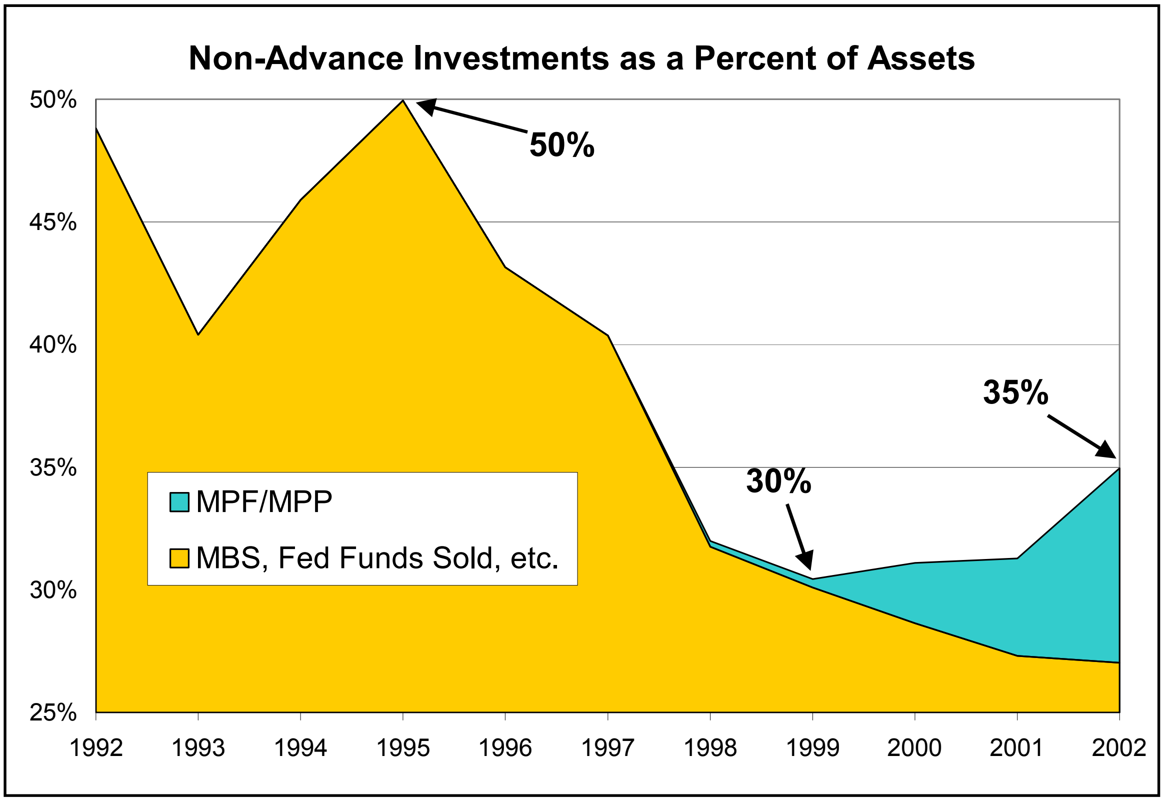
[16] Testimony of Assistant Secretary of the Treasury Rick Carnell before the House Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises "Federal Home Loan Banks" (Sept. 24, 1998)

Partnership Finance program (MPF) pioneered by the Home Loan Bank of Chicago begun in 1999, followed by the Mortgage Partnership Program (MPP) instituted by the Cincinnati, Indianapolis, and Seattle Banks in 2000. From 2000 to 2002, the System's cash and non-advance investments declined as a percentage of assets, from 29% to 27%. However, mortgage purchases under MPF and MPP exploded. In 2000, the first year both programs became operational, $16 billion was invested in mortgage purchases. By the end of last year, that number had climbed to $60 billion. At the end of 2002, mortgages held in portfolio accounted for 7.9% of assets, up from 4.0% in 2001.[17]



This change in the balance sheet of the System has been accompanied by proposals to make even more far-reaching changes in its structure and mission by considering multi-district membership and an even more aggressive role in the secondary mortgage market. These changes could fundamentally alter the role the System has served for over 70 years.

The Push For Multi-District Membership

The Federal Home Loan Bank Act of 1932 established the Federal Home Loan Bank Board and authorized it to establish and oversee eight to twelve regional Banks. Pursuant to that authority, the Board created twelve districts. The 1932 Act, as amended, stated that:

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[17] FHLB 2002 Annual Report, at 22

> An institution eligible to become a member or a nonmember borrower under this section may become a member *only of*, or secure advances from, the Federal Home Loan Bank of the district in which is located the institution's principal place of business, or of the Federal Home Loan Bank of a district adjoining such district, if demanded by convenience and then only with the approval of the Board. (Emphasis added.)

Currently, each member of the System is a member solely of the district Bank where the member maintains its principal place of business. No single institution has been a member of more than one district Bank, though some holding companies own separately chartered subsidiaries that are members of different Banks.[18]

Consolidation has led some System members to seek out multi-district memberships to allow them membership in districts where they are not headquartered or to avoid what they view to be unnecessary and excessive costs attendant with maintaining separate charters within a holding company.

In response to these petitions, the FHFB started a formal process of soliciting comments, with the comment period expiring in the spring of 2002. The FHFB received several comments questioning its legal authority to permit multi-district memberships, (including a letter by the author when I served as Assistant Secretary for Financial Institutions).[19] The FHFB then took the somewhat unconventional step of contracting with an outside law firm, Morrison and Foerster, (instead of relying on its in-house legal staff) to provide it with a legal opinion as to whether it had the power to extend multi-district membership privileges.

An agency's own legal staff is generally viewed as the leading source of expert advice regarding that agency's authorizing statute. When an agency is uncertain about the scope or meaning of its authorizing legislation, the more typical course is to seek an opinion from the Justice Department's Office of Legal Counsel, or to seek clarifying legislation from Congress.

The outside legal opinion reached the astonishing conclusion that not only did the statute authorize the FHFB to permit multi-district membership, but *required* it to do so if necessary to carry out the FHFB's mandate that the FHLBanks operate in a safe and sound manner.[20] The FHFB then adopted a resolution requesting information from the twelve Federal Home Loan Banks "regarding the changing financial services industry, and its effect on terms of membership in the Banks."[21] Upon issuing the resolution,

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[18] See the FHFB's Solicitation for Comments on Multi-District Membership, at p. 2. The FHFB reports that 104 depository institution holding companies have subsidiaries that are members of different district Banks.
[19] "[T]he statutory language of Section 4(b) as well as the legislative history of the provision raise considerable doubt as to whether the Finance Board has the authority to approve multi-district membership." Letter Sheila Bair, Assistant Secretary for Financial Institutions, Treasury Department, to Elaine Baker, Secretary to the Board, Federal Housing Finance Board, April 9, 2002.
[20] Letter from Morrison and Foerster to John Korsmo (December 9, 2002).
[21] Resolution 2002-63 (Dec. 20, 2002)

Chairman Korsmo indicated his hope to present "a final regulation to modernize membership terms" no later than the FHFB meeting in June 2003.[22]

The question of multi-district membership has been highly controversial among the FHLBanks' Presidents. Less than half have expressed support for it: Chicago, Dallas, New York, Pittsburgh and Seattle. Four have vigorously weighed in against the petitions: Atlanta, Des Moines, San Francisco and Topeka. The remaining three—Boston, Cincinnati and Indianapolis—are undecided but all have expressed reservations about moving forward without additional analysis and greater consensus.[23]

The Lack of Legal Authority for Multi-District Membership

The threshold question regarding multi-district membership is whether the FHFB has the legal authority to permit it, given the strictures of the above-quoted language. In its opinion to the board, Morrison and Foerster concluded that this language was ambiguous on the question:

> [T]he better view is that the Act authorizes the Board to promulgate a regulation allowing an FHLBank to grant membership to a member of another FHLBank, to the extent that the regulation furthers the mandate imposed by Congress on the Board, including that the Board "ensure that" FHLBanks "operate in a financially safe and sound manner," "carry out their housing finance mission," and "remain adequately capitalized and able to raise funds in the capital markets."

The opinion gave short shrift to the fact that the language of Section 1424(b) had been viewed throughout the 70-year history of the System as limiting membership to one district, and did not even cite FHFB Regulation 925.4(b)(1) which provides:

> Upon consolidation of two member institutions which are members of different Banks into one institution operating under the charter of one of the consolidating institutions, *the disappearing institution's membership terminates upon cancellation of its charter.* (emphasis added).

The opinion also did not discuss express legislative history cited in the FHFB's own petition for comments, which appears inconsistent with its interpretation of Section 1424(b). The petition quotes the principal drafter of the Bank Act as stating:

> [I]t was not the desire, say, for members in South Carolina to borrow of a New York bank, because it would mean *too great a concentration at the New York bank. If the New York bank happened to do better than a South Carolina bank, all members would go there.* There is the opportunity in the bill for a member whose principal place of business is in one district to belong to a bank in the adjoining district, but outside of that, there is no

[22] FHFB Press Release (December 20, 2002)
[23] The complete text of comment letters can be found at ttp://www.fhfb.gov/pressroom/responses2003.htm.

> provision. It is impossible under the terms of the bill for a company doing business in New York to belong to a South Carolina bank.[24]

This emphasis on the regional nature of the System, combined with the fear of membership concentrations at the larger FHLBanks, supports reading Section 1424(b) in a manner consistent with its plain meaning, i.e., that a System member may belong to only one district: that in which its principal business is located, *or* the adjoining district. This interpretation is also consistent with extensive legislative history that the FHLB System was patterned after the Federal Reserve System, which, pursuant to its own authorizing statute, allows an institution to be a member of *only one* district Reserve Bank.

The fact that Section 1424(b) gives members the option of joining their home district, or the adjoining district, is simply reflective of the realities of transportation and communication in 1932. A World Savings letter arguing against multi-district membership pointed out that: "It would have been considerably more convenient, for example, for an institution in western Maryland to join the FHLB of Pittsburgh, which is only 100 miles or so away, than to join the FHLB of Atlanta, which is at least 650 miles away and, especially in 1932, would have been far more difficult to reach by rail or road."[25]

The Federal Reserve Act gives a similar option to Federal Reserve System members of joining their home district Bank, or another district for "convenience" but members must still belong to only one Reserve Bank

The legal opinion concedes that this tortured interpretation of Section 1424(b) is "not free from doubt," but goes on to suggest the strictures of this section can be ignored if necessary to achieve other mandates imposed by Congress, including the broad goals of ensuring that FHLBanks "operate in a financially safe and sound manner," "carry out their housing finance mission," and "remain adequately capitalized and able to raise funds in the capital markets."

By this reasoning, when Congress granted the Board safety and soundness and mission authority, it authorized the Board to rewrite the statute however it pleases. Such an interpretation could, in essence, allow any financial regulator to ignore congressionally imposed charter limitations if necessary, in that regulator's judgment, to assure safety and soundness, mission achievement, or adequate capitalization.

Would Multi-District Membership Promote Safety and Soundness?

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[24] *Notice and solicitation of comments, Multiple Federal Home Loan Bank Memberships*, Federal Housing Finance Board, available at http://www.fhfb.gov/PressRoom/petitions/Solicitation092601.htm.
[25] World Savings Request to Intervene in Dallas Petition (February 21, 2001)

A leading argument in favor of multi-district membership is that it would help prevent excessive concentrations of advances at individual district Banks with a single member. Proponents of this view point to heavy single borrower concentrations at several district Banks, and argue that this "problem" would be exacerbated if, given the current pace of consolidations, merged institutions were required to consolidate advance activity at the FHLBank of the surviving merged entity. They also argue that the FHLBank losing a member as a result of a merger could suffer a dangerous depletion of capital.

It is difficult to understand why current consolidations present a problem that needs addressing. The system proved to be remarkably adaptable throughout the seismic consolidation activity that occurred in the late 1980's, while adhering to the principle of single district membership. At that time, as well as during more recent consolidation trends, the Banks have shown that they were fully capable of expanding and contracting in accordance with the needs of their members. That flexibility lies at the heart of the System's core mission. As the San Francisco Federal Home Loan Bank stated in a comment letter opposing multi-district membership,

> [T]he FHLBanks were designed from their inception to expand and contract according to the needs of their members. This simple truth applies whether the member in question is operating in a single small town on a seasonal grow-and-shrink cycle or operating nationwide with ever-expanding needs based on successive mergers and acquisitions. …
>
> [N]o bank has ever been assured that its membership or assets will be maintained at a given level, and there is no reason for the Finance Board to seek to provide this assurance now by changing the membership rules."[26]

The San Francisco Bank was not describing a hypothetical situation in positing the ability of an FHLBank to shrink or expand. In 2002, the Bank's own advances declined from $102 to $81 billion and its assets from $135 to $116 billion primarily as a result of its members strong retail deposit growth and mortgage prepayments.[27]

Moreover, it is unclear that borrower concentration at individual district Banks is the "problem" proponents of multi-district membership make it out to be.

First, it is questionable whether borrower concentrations do present a safety and soundness issue. Given current requirements for collateralization and capital held against advances, there is little chance that an FHLBank would suffer a credit loss even if its

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[26] Letter to Elaine Baker, Secretary to the FHFB Board from Dean Schultz, President and CEO, Federal Home Loan Bank of San Francisco. (Feb. 6, 2003)

[27] Interestingly, the significant decline in advances at the San Francisco Bank was caused by its largest members but had no relationship to the supposed problems created by restrictions on multi-district membership. "The decline in advances outstanding was primarily the result of several members' strong retail deposit growth and mortgage prepayments. The Bank's largest members accounted for most of the decline in advances." 2002 Annual Report, Federal Home Loan Bank of San Francisco at 25.

largest borrower were to become insolvent. FHLBanks typically require security 10 – 25% higher than the value of an advance when the collateral is a mortgage. They can require 60 – 150% more when the collateral consists of small business or farm loans.[28] With such generous amounts of collateral against advances, as well as the borrower's capital stock, credit risk is virtually eliminated.

Second, if there is a problem of concentration, it is a problem that applies to the *System's* exposure to a small number of large borrowers, not the exposure of individual Banks. Because the consolidated obligations that support each district Bank's lending activity are the joint and several liability of all district Banks, it is ultimately the System, not the individual district Bank, that would have to make up for shortfalls resulting from a large borrower's default.

There is no reason to think multi-district membership would do anything to mitigate the System's exposure to concentrated borrowings by a few large institutions. It is just as likely that the ability to become a member of multiple district Banks would increase a large borrower's activity in the System as a whole. In addition, allowing one member to have multiple relationships with FHLBanks would increase operational risk since they lack safeguards to obviate the multiple pledging of collateral or clash of competing blanket liens. As the Topeka FHLBank stated in its comment letter:

> We strongly believe that having a single point of credit management relating to a single financial institution charter creates significantly less risk than would a situation where multiple FHLBanks are trying to manage competing credit relationships with the same institution.[29]

Multi-District Membership Could Destabilize the System

Far from enhancing safety and soundness, it appears more likely that multi-district membership could have a destabilizing effect on the System, putting large institutions with multi-district memberships in the position of being able to "shop" their advance activity to multiple Banks. A World Savings letter ~~to the FHFB~~ stated:

> [T]here will be a very high temptation for all the Banks to compete on some basis for business of large multiple members, and that competition is likely to be cut throat. Members quickly would shop for Banks with lower capital requirements, or lower advance rates, or more favorable MPF criteria or more lenient collateral requirements. … A kind of race to the bottom would inevitably result, as we have seen in all-too-numerous other credit situations.[30]

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[28] GAO Report "FHLB System: Establishment of a New Capital Structure" at p. 14.
[29] Letter to the Honorable John Korsmo, Chairman, FHFB, from Andrew Jetter, President and CEO, FHLBank of Topeka. (February 7, 2003)
[30] Letter to the Multi-District FHLBank Membership Roundtable from Herb Sandler, Chairman and CEO, World Savings (Jan 8, 2002)

Concern about the potential destabilizing impact of multi-district membership on credit standards was a recurring theme in letters filed by FHLBanks opposed to multi-district membership, and was also cited by undecided Banks. As the San Francisco Bank put it:

> Competition would not occur in pricing past a certain point, because the FHLBanks can employ the same funding strategies and raise funds at substantially the same cost. Competition would then have to occur in credit and collateral standards and procedures. An FHLBank that lowers its standards would win more multi-district members, but would increase risk for the System—that is for the FHLBanks that didn't lower their standards, but yet remained jointly and severally liable for risk taker's debts.

Even though a supporter of multi-district membership, the president of the Seattle FHLBank has acknowledged this as an issue:

> [M]ultidistrict membership will increase competition amongst the district banks. Given that the Federal Home Loan Banks all raise funds the same way, no bank can have a lasting price advantage. Unable to compete on price, there's the possibility that we'll compete on collateral and credit standards. And unless regulatory changes are made, that could be very risky for everyone.[31]

Among undecided banks, the FHLBank of Boston was typical in stating it was "particularly concerned about the potential for destabilizing competition among the Banks on both price and non-price issues such as credit underwriting and collateral which may adversely effect the System's risk profile and raise safety and soundness concerns."[32]

Diminution of credit quality by large FHLBank System borrowers would have adverse ramifications not only for the System, but the FDIC as well. This is because FHLBanks have a "super lien" that is superior to all other creditor claims in the event of a member institution's insolvency—a lien that takes precedence even over the claims of FDIC-insured depositors (and of the FDIC as receiver).

This super lien can be expensive to the FDIC when it is forced to take over an insolvent institution with significant outstanding FHLBank advances. The FDIC will typically take over an insolvent institution on a Friday afternoon, giving it the weekend to line up a purchaser before the bank is scheduled to re-open on Monday. The problem: advances are secured by liquid, high quality assets—the kind that would be attractive to potential purchasers.

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[31] Address to Stockholders, Norman B. Rice, President, FHLBank Seattle, May 14, 2003.

[32] Letter to Elaine Baker, Secretary to the Board, FHFB, from William P. Morrisey, Chairman; David Holland, Chair, Multi-District Membership Task Force; and Michael Jesse, President and CEO, FHLBank of Boston.

To preserve these assets (and with little time to negotiate with the FHLBank), the FDIC is forced to pay off the advances in full. Because the advances are paid off prior to maturity, the FDIC generally must also pay a prepayment penalty to the FHLBank. These prepayment penalties are calculated based on what it will cost the FHLBank to unwind its interest rate hedge on, or otherwise replace, the advance, and can thus be significant on a long-term advance which carries an above-market rate.

The failure of the Bank of Alamo last year presents a severe example of how costly these prepayment penalties can be. The FDIC was forced to pay off $6.4 million in advances, plus another $906,000—a whopping 14%—in prepayment penalties.[33]

Because of the adverse effects heavy FHLBank borrowing by a failed bank can have on FDIC reserves, the agency takes a keen interest in large concentrations of advance activity in individual FDIC-insured institutions. Last fall, it conducted an extensive safety and soundness analysis of 80 of the FHLBank System's largest borrowers that are supervised by the FDIC.[34] These included 46 state banks and 34 mutual savings banks, with average assets of approximately $520 million.

The average advance-to-total-asset ratio at these institutions ranged from 14 to 51%, with the average being 29%. The good news: 78 of the 80 institutions have composite CAMELS ratings of 1 or 2. Only two had a less acceptable composite rating of 3. Based on the high supervisory ratings of the vast majority of FHLBank borrowers, the FDIC staff found that their concentrated borrowings did not present a major supervisory concern.

The FHFB and district Banks should take some pride in this finding by the FDIC staff. It also underscores an important point made by opponents of multi-district membership: that currently there is no problem regarding the concentration of advances, and "if it ain't broke, don't fix it." The current structure seems to be providing the right balance for prudent lending practices. The introduction of competition among district Banks through multi-district membership, however, could very well destabilize current practices and result in a deterioration of credit standards for large borrowers.

Multi-district Membership Would Benefit Only Large Lenders

Finally, of course, from the point of view of the membership of the Bank System, the push to multi-district membership is, almost by definition, an attempt to accommodate large members. By their very nature, community banks will not be seeking membership in multiple Banks. Proponents have argued that multi-district membership will benefit smaller institutions who will enjoy the "trickle down" effect of more favorable pricing resulting from FHLBanks competing with each other for the business of large, multi-district members. However, as discussed above, far from promoting more efficient

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[33] Briefing Paper "Federal Home Loan Bank System" (Office of the Chairman, FDIC, distributed at the April 22, 2003 Meeting of the FDIC Banking Policy Advisory Committee.)
[34] Because the analysis was confined to FDIC supervised institutions, this analysis did not include many large thrift and commercial bank users of the System.

pricing, competition among the Banks would more likely result in a diminution of credit and collateral requirements.

"Modernization" has also been a leading catchword to promote multi-district membership. But what does "modernization" mean in the context of GSEs? Most GSEs were created in the aftermath of the great Depression, to address a market failure in the provision of credit in key economic sectors. If "modernization" is the rationale for supporting fundamental changes in GSE structure without statutory support, where do we draw the line?

In short, there are good reasons why the Federal Home Loan Bank Act does not allow multi-district membership. It is simply not compatible with the law or the basic concept of the System—a cooperative consisting of regional Banks tied together by the joint raising of funds and the joint liability for the resulting obligations. With multi-district membership, the Banks could not compete for members' business with each other based on the cost of funds. Instead, the temptation would be to compete based on relaxed credit and collateral standards. Therein lies folly.

The Mortgage Purchase Programs

In 1997, the FHFB granted authority to the FHLBank of Chicago to initiate a pilot program called "Mortgage Partnership Finance" (MPF), which allowed the Bank to directly acquire mortgages originated by its members. The Chicago FHLBank designed the program as a strategic alternative for its members to holding loans in portfolio or selling them in the secondary market. Under the program, the Chicago FHLBank buys mortgages and holds them in portfolio, fully assuming the interest rate, liquidity and prepayment risk associated with the loans. The member retains marketing, servicing, and part of the credit risk—the latter through credit enhancements established by the Chicago FHLBank.

Originally capped at $750 million, the pilot was a major success and the now-permanent program has grown exponentially—reaching $42.3 billion last year, with all but three of the Federal Home Loan Banks participating. The remaining three, Seattle, Cincinnati, and Indianapolis started their own, substantially similar program, the Mortgage Purchase Program (MPP) in 2000.[35] That program, at the end of last year, had grown to $18 billion.

MPF was controversial when it was first approved. An unsuccessful legal challenge was brought to the FHFB's authority to approve the program based on the fact that there is nothing in the Bank System's legislative history or authorizing statute granting authority for direct mortgage purchases, and two other GSEs, i.e., Fannie Mae and Freddie Mac, were established and chartered expressly for that purpose. The court, however, upheld the FHFB's action, based on the strong deference generally given to agencies in interpreting their own authorizing statute.[36]

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[35] The FHLBank Atlanta participates in both programs.

[36] Texas Savings & Community Bankers Association, et al vs. Federal Housing Finance Board, 201 F. 3rd 551 (5th Cir. 2000) The Court upheld the FHFB's approval of MPF under Chevron v Natural Resources

Though controversial, analysts assumed until recently that MPP and MPF could not become a significant factor in the trillion-dollar secondary mortgage market because of charter limitations and the Banks' capital structure.[37] When an FHLBank buys a mortgage, it becomes an asset on the Bank's balance sheet. Thus, under the 4% capital-to-asset ratio adopted by the FHFB, the Bank must attract sufficient capital to assure that it maintains this 4% ratio as the volume of mortgages held by the Bank grows.

Publicly traded companies, such as Fannie Mae and Freddie Mac, can access the capital markets through public stock offerings to maintain sufficient capital to support expanded acquisitions. An FHLBank, however, can only raise additional capital through stock purchases by its members. In addition, Fannie and Freddie make greater use of retained earnings to build capital, whereas the FHLB System tends to pay out more of its earnings in dividends.[38]

Fannie and Freddie can also serve originators by securitizing mortgages that can be sold to the public as mortgage backed securities, or MBS. The FHLBanks' charter does not authorize them to securitize mortgages to get these assets off their balance sheets.

If these programs are truly meant to acquire mortgages from smaller institutions, FHLBanks could issue new capital stock to members selling loans to them, build retained earnings or replace non-advance investments with MPF/MPP loans. Securitization would only seem to be necessary to accommodate wholesale acquisition of mortgages from large lenders.

Charter limitations notwithstanding, securitization has been embraced by MPF/MPP advocates.[39] Such a step, however, is flawed on both legal and economic grounds. While Congress has reviewed the System on several occasions, it has repeatedly declined to provide any authority to securitize mortgages.

In addition, a committee of FHLBank chief financial officers was reportedly unenthusiastic about the economic viability of a securitization program.[40] Pointedly,

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Council, 467 U.S. 837 (1984) which requires the federal courts to give heavy deference to agency interpretations of statutes they administer.

[37] See, e.g., "FHLBs Lack Structure to Dent Fannie and Freddie, Report Says" (American Banker Sept. 16, 2002) and Specialty Finance: Mortgage Stuff Ideas, Gary Gordon, UBS Warburg, September 12, 2002.

[38] In 2002, the FHLBanks paid 51% of their income in cash dividends. (They paid another 46% in stock dividends, for a total of 97%, but such dividends represent a transfer from retained earnings to the capital stock account rather than a diminution in capital). Fannie Mae paid 23% of its net income in dividends, Freddie Mac 15%. Since 1980, the System's capital to asset ratio has declined from 11% to 4.76%, which appears to be due, at least in part, to its operating philosophy of paying out a large portion of earnings as dividends as well as the redirection of retained earnings to pay for the thrift clean up.

[39] "Going forward, securitization of MPF assets will become an increasingly important priority for us." James D. Roy, President FHLBank Pittsburgh at http://www.fhlb-pgh.com/news_pub_7-17.html.

[40] "The Federal Home Loan banks' booming mortgage-purchase programs will eventually drive them to seek more capital, but the most obvious source—loan securitizations—currently does not appear to be a viable option, according to a draft internal report… The problem, according to the draft, is the fact that the lenders retain the credit risk on the loans they sell, while the Home Loan banks take on the interest rate

however, FHLBank Chicago was not represented on the CFO committee. Indeed, securitization seems to be the direction in which the Chicago FHLBank is heading with its new "Shared Funding Program."

The Shared Funding Program

The Shared Funding Program was quietly approved by the FHFB staff last December, with virtually no meaningful public discussion or input.[41] As discussed below, this program allows the Chicago Bank to circumvent charter limitations on its own issuance of MBS by partnering with one of its member institutions. Shared Funding provides a potential vehicle for MPF and MPP to grow significantly, raising concerns anew about the inconsistency of these programs with the FHLBank System's charter, structure and capabilities.

Under the Shared Funding Program, MPF-eligible loans are sold to a *membe*r of the Chicago Bank, which then issues its own "private label" securities backed by these loans. Two tranches of securities are created, with the senior tier being sold to the Chicago Bank or other FHLBanks participating in MPF, which may in turn sell some or all of the securities to System members. The member securitizing the loans may sell the subordinated tier of securities anywhere in the capital markets or hold them in portfolio. As described in a recent issue of *Inside Mortgage Finance*, a widely read trade journal in the mortgage finance industry, "The Chicago FHLBank … got around the obstacles facing direct Bank issuance of MBS by creating a program where the Banks support what amounts to a non-agency, private label MBS program as investors."[42]

The Chicago FHLBank completed its first Shared Funding transaction on March 21, 2003. The $475 million offering was backed solely by MPF loans originated by Wells Fargo Home Mortgage and National City Mortgage, two of the biggest mortgage originators in the country. FHLBank member Bank One created the conduit to issue the securities. Because these were private placements not subject to SEC registration requirements, important details were not disclosed about the collateral and structure of the offering.[43]

According to *Inside Mortgage Finance*, the senior classes of the transaction were purchased by the FHLBanks of Chicago, Des Moines, and Pittsburgh, with Bank One acquiring the subordinated classes. Perhaps the biggest question about the offering was

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risk. If the loans were then securitized, the banks would be laying off to investors the interest rate risk, which generates the majority of the return." *Will FHLB Loan-Buying Plans Hit Capital Wall?* Rob Garver, *American Banker*, September 27, 2002

[41] Letter to Alex Pollock, President, FHLBank of Chicago from Arnold Intrater, FHFB General Counsel (December 4, 2002)

[42] *Inside Mortgage Finance,* March 28, 2003, at p. 5.

[43] Not even to other Federal Home Loan Banks who are partners with the Chicago Bank in MPF and who are liable for consolidated obligations issued by the System on behalf of the Bank. As Raymond Christman, President of the Atlanta FHLBank, stated in a letter to Congressman Harold Ford on April 29: "[I]t is unfortunate that full disclosure and public understanding of the recently developed MPF Shared Funding Program did not occur."

how the price Wells Fargo and National City Mortgage received compared to prices offered by Fannie Mae and Freddie Mac. Industry speculation is that the FHLBanks paid generously for the Shared Funding MBS "since the securities are treated as 'member assets' for regulatory purposes and are not subject to the cap applied [FHL]Bank investments in agency MBS as a percent of capital."[44]

SFP is a private-label MBS rather than a securitization of the Chicago FHLBank. However, at least one FHLBank President has characterized it as a stepping stone to such a program being adopted by the Bank System or individual Banks.[45,46] What is all the more extraordinary about this step being taken is the fact that a committee of FHLBank Chief Financial Officers found that securitization was not a good business decision for the System.[47]

The study concluded, according to reports, that "under the current system a securitization program would lose money, even in the best-case scenario."[48]

So if securitization generates losses for FHLBanks, and is unnecessary to serve small community lenders, whose interest does it serve? The conclusion is inescapable. The beneficiaries will be the large members of the Bank System.

These large members are already the drivers in the MPF and MPP programs. Supporters of MPF and MPP routinely claim that the programs benefit small, community-based lenders with a more favorable pricing structure, because they are compensated for retaining the credit risk of the mortgages they originate. But available data suggest that it is the nation's largest mortgage originators who are primarily benefiting from the programs. A trade journal recently identified Wells Fargo Home Mortgage (at $11.7 billion) and National City Mortgage (at $11.3 billion) as the top two in mortgage sales to the FHLBanks in 2002. The same article reported that the top five institutions sold $42.7 billion in mortgages to the FHLBs.[49] If this report is accurate, these five institutions would account for almost all of the $45.7 billion dollars in FHLBank mortgage acquisitions in 2002.[50]

Safety and Soundness Considerations with Mortgage Acquisitions

A fundamental selling point in the marketing of the MPF/MPP programs is the unbundling of risks associated with a mortgage, and assignment of those risks to the

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[44] *Inside Mortgage Finance,* Id.
[45] Norman B. Rice, *Id*. at fn. 28~~7~~ "You may have already heard that the Chicago Bank recently was approved for a limited securitization program that involves only Federal Home Loan Bank members. This is a first step."
[46] Not all FHLBanks agree that it is a necessary step. In describing its MPF purchases, FHLBank New York said in its 2002 Annual Report: "We have no need to securitize these assets."
[47] See, *Will FHLB Loan-Buying Plans Hit Capital Wall?*, Rob Garver, American Banker, Page 1, September 27, 2002
[48] *Id.*
[49] *Inside the GSEs* (April 2, 2003) at 6.
[50] 2002 FHLBank System Annual Report at 22.

institution best suited to manage them. As described by the Chicago FHLBank, "[T]he Federal Home Loan Banks are responsible in an MPF transaction for managing the interest rate risk, prepayment risk and liquidity risk of the fixed-rate mortgages because of their expertise at hedging such interest rate risks and their ability as a GSE to raise low-cost, long-term funds in the global capital markets."[51] The description also indicates that because "lenders know their customer better" they are given the primary responsibility of managing the credit risk, as well as other functions involving the customer relationship such as marketing and servicing. [52]

The FHLBanks may well have greater expertise and capability in managing certain kinds of interest rate risk than a small, community-based lender. However, it defies credibility to think that they have expertise superior to institutions like Wells Fargo Home Mortgage or National City Mortgage in managing the interest/prepayment risks associated with mortgages. Yet these large mortgage originators are precisely the type of institutions dominating the System's mortgage acquisition programs.

Operational risk may be the most significant new risk the Banks face in acquiring mortgages. There is a serious question as to whether the FHLBanks have sufficient numbers of qualified staff to build the needed infrastructure and manage even the day-to-day foreseeable risks associated with major secondary mortgage market participation. To be sure, the FHLBank System employs a number of highly talented, dedicated professionals—and total staff across the System comes to 2,183 employees. However, they are spread out among twelve Banks and the Office of Finance and have traditionally been focused on supporting the System's core mission of providing advances, which involves risks significantly different from those associated with mortgage acquisition or securitization.

Moreover, the staff of each FHLBank is relatively small. The Office of Finance, which issues the consolidated obligations that support FHLBank activity, employs only 57 people. The full-time staffs of the individual Banks range from 122 (Seattle and Dallas) to 278 (Atlanta). The Chicago FHLBank employs 218 full-time staff. This compares to the 3,900 employees of Freddie Mac, and nearly 5,000 at Fannie Mae, managing combined mortgage portfolios of $1.3 trillion. These huge disparities underscore concerns that the FHLBanks are ill-equipped to undertake a major foray into the secondary mortgage market.

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[51] Providing interest-rate and prepayment risk protection rings hollow as a justification for MPF/MPP. In their established advance business, the FHLBanks insist that they themselves be protected against interest rate risk at the expense of the borrowing member: "[E]ach FHLBank generally charges a prepayment fee that makes it financially indifferent to a borrower's decision to prepay an advance." Federal Home Loan Banks' 2002 Financial Report at 36. In fact, with the popular so-called convertible advances, which can be put back by the FHLBank to the member, both the FDIC and the FHFB have complained that the FHLBanks are essentially ***increasing*** members' interest rate risk. See, *Refinancing Waves Alter the Landscape for Mortgage Specialists*, FDIC, April 25, 2002 and *Profile of the Federal Home Loan Bank System December 31, 2001*, Office of Policy, Research and Analysis, Federal Housing Finance Board.
[52] "How the MPF Program Works" www.fhlbmpf.com/MPF.

With regard to credit risk, though MPF/MPP are designed to assign this risk to the originating institution, the FHLBank still maintains some exposure. As acknowledged in the FHLB System's third quarter financial statement, "[mortgage] assets may have more credit risk than advances, even though the member or housing associate provides credit enhancement."[53]

As with mortgages sold to Fannie Mae or Freddie Mac, MPF loans with down payments of less than 20% are required to have private mortgage insurance. In general, losses beyond this are absorbed by a "first loss account" established by the FHLB. "Second losses" beyond this layer are absorbed by the member through reductions in the monthly "credit enhancement fees" paid by the FHLBank. However, the adequacy of enhancements established by Chicago and the other FHLBanks are essentially dependent on their expertise in interpreting historical default data to estimate credit losses, which again is outside their traditional mission and experience in making advances. The FHLBank is responsible for losses beyond the member's exposure.

Questions about the capability of the FHLBanks to manage new risks associated with their mortgage purchase programs are heightened by longstanding weaknesses in the FHFB examination processes, identified by the Government Account Office (GAO) in 1998 and again in 2002. Though Chairman Korsmo has taken a number of steps to address these weaknesses, including increasing the number of examiners and putting greater focus on major risks and the quality of controls at FHLBanks, the GAO found in a report released in February of this year that it is still too soon to evaluate the effectiveness of these measures.[54]

The FHLBank's SEC Exemption

On July 16, 2002, with strong White House backing, Treasury Under Secretary for Domestic Finance Peter Fisher called upon all three of the major housing GSE's to register their stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934. Though Fannie Mae, Freddie Mac, and the FHLB System enjoy statutory exemptions from SEC registration requirements—another benefit of their GSE status—Fisher pointed out that as "large rapidly growing and important players in our capital markets and in our banking system…they need to be role models for our system of investor protection, not exceptions to it."[55]

Four days prior to Fisher's statement, Fannie Mae and Freddie Mac had announced their decision to voluntarily register their stock as provided under Section 12(g) of the '34 Act with strong public support from Fisher and then-Treasury Secretary Paul O'Neill. A few days after Fisher's statement, FHFB Chairman John Korsmo announced his support for "full disclosure requirements for the Federal Home Loan Bank System" and indicated that he had initiated talks with the Securities and Exchange Commission and the

[53] FHFB 2002 Third Quarter Report, at 22.
[54] GAO Report "Review of Selected Operation of the FHFB" (February 2003)
[55] Testimony of Peter Fisher before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (July 16, 2002) at http://www.ustreas.gov/press/releases/po3259.htm.

Department of Treasury about expanding financial disclosure reporting in response to Fisher's call. Korsmo also added, "I firmly believe that the public has a right to know at least as much about the Home Loan Banks as they do about the publicly traded companies in their retirement funds." [56]

Korsmo's willingness to engage Treasury and the SEC on the '34 Act registration issue has been controversial among the FHLBanks and its members. In general, the Banks have argued[57] that because their stock is not publicly traded, but rather held by System members, and because they are separately regulated by the FHFB, the regime established under the '34 Act does not "fit" their situation. They maintain they are not opposed to full disclosure, in accordance with SEC requirements, but feel those disclosures should continue to be filed with, and regulated by, the FHFB.

The Banks have pointed out that federally chartered banks enjoy a similar exemption from '34 Act registration, and are required only to file their corporate disclosures with the federal bank regulators.[58] They have further expressed concern that '34 Act registration could lead the SEC to impinge on the FHFB's authority as their safety and soundness regulator.[59] On December 17, 2002, Korsmo announced that he was deferring action on ~~both~~ proposals to register the System's debt and capital stock with the SEC pending further discussions, though he continues to speak out for improved disclosure.

The FHLBanks and their members argue that their cooperative structure makes them different from publicly traded corporations, but this is not a valid basis for escaping SEC scrutiny of public financial statements and other required disclosures.[60] In fact, absent an SEC exemption, the Banks would be required to file periodic reports under the Securities Exchange Act of 1934 due to either the public offering of their debt securities[61] or the number of common shareholders.[62]

The Administration is trying to promote consistency and comparability in disclosures to investors, and the SEC, as lead overseer of corporate disclosures, is the obvious vehicle for accomplishing that objective. Concerns about the SEC potentially interfering with the FHFB's role as safety and soundness regulator are misplaced. The '34 Act registration regime is based on *disclosure.* SEC review of corporate filings is focused on ensuring their accuracy and fairness, not the financial integrity of the company.

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[56] FHFB Press Release, July 16, 2002. "FHFB Chairman Embraces Call for Full Disclosure"
[57] See, e.g., FHFB Public Hearing on Disclosure (December 2, 2002)
[58] Though this is a valid point, it should be noted that the largest federally chartered banks, typically operate under a holding company structure, which is publicly traded and regulated by the SEC.
[59] The SEC has a long history of working cooperatively with the federal banking regulators due to its regulation of bank and thrift holding companies.
[60] Cooperative status does not in itself bestow an SEC filing exemption. There are numerous cooperative associations who are required to file periodic reports under the '34 Act.
[61] The Bank System is one of the world's largest issuers of debt securities. Under the SEC's integrated reporting system, issuers of debt securities in public offerings must file periodic SEC reports under Section 15(d) of the '34 Act.
[62] Section 12(g) of the '34 Act requires entities with more than $1 million in assets to register securities held by more than 500 investors, absent an SEC exemption. Six of the twelve FHLBanks (Des Moines, Atlanta, Chicago, Dallas, Topeka and Cincinnati) had more than 500 investors as of December 31, 2002.

Technical arguments made by the FHLBanks regarding their unique cooperative status also are misplaced. Whether the FHLBanks register their stock or their debt securities under the '34 Act is not important.[63] What is important is bringing the FHLBanks within the SEC's periodic reporting regime. The registration of Fannie Mae's and Freddie Mac's common stock brings these companies within the '34 Act reporting system, which benefits not only their stockholders but the holders of their debt securities as well. While the FHLBanks may not be concerned with the level and quality of financial disclosures provided to their member institutions (i.e., their stockholders), policymakers should be concerned with the level and quality of financial disclosures to their public debt holders.

Moreover, if, as the FHLBanks claim, they are already fully disclosing that which is required under the '34 Act, this seems like a debate of form over substance. By resisting SEC registration, the FHLBanks create the perception that the System is resisting transparency, an untenable position in this post-Enron environment. Such lack of transparency only exacerbates concerns that as the FHLBanks take on new business ventures, the risks will not be apparent to the taxpaying public that could end up footing the bill.

[63] It appears the Administration's main concern is to achieve periodic information filed with the SEC about the FHLBanks and the System as a whole. In the author's view, one possible approach would be for the SEC to apply an "entity" registration regime to address concerns that registration requirements associated with individual securities issuances could impede the ability of the FHLB System to access the markets at critical junctures.

Conclusion

New ventures like mortgage purchase programs and privately placed securitizations, perched precariously atop a system based on joint and several liability with limited public disclosures are trends that I find deeply alarming. What will happen if these programs continue to grow unchecked? If, in pursuing dreams to become a major competitor in the secondary mortgage market, the System assumes major new risks that it is ill-equipped to manage, will these programs topple and fall, bringing down the entire System with them?

The System was able to survive the S&L debacle primarily through the lobbying clout of community based institutions, and its populist, historic mantle as friend to small, community-based thrifts. Those institutions were also instrumental in many of the beneficial provisions enacted as part of GLBA. Yet, the changes taking place now primarily benefit the System's largest members, and are alienating many of the smaller, independent institutions, which have long been part of its core constituency.

The System is taking risks for which it is not prepared, and inviting scrutiny and controversy by forging ahead with activities that far exceed its Congressional charter and with which it has no historic experience or expertise.

The thrift experience has shown that lenders cannot safely rely on short-term deposits to fund long-term fixed-rate mortgages; access to capital market funds is necessary. Congress has settled on two GSE models whereby financial institutions, particularly community banks, active in the mortgage market can gain such access. One is through securitizing and selling loans through Fannie Mae or Freddie Mac. The other is through holding loans in portfolio financed with Federal Home Loan Bank advances.

Through its advance business, the Bank System already provides competition to the other two housing GSEs since it offers member institutions the basic opportunity to hold long-term~~fixed-rate~~ mortgages safely in portfolio instead of having to sell them into the secondary market.

Every indication shows that the vast bulk of the System's membership, as distinct from a handful of its largest members, values advances far above any other service the FHLBanks can provide. Yet, the Chicago and Pittsburgh banks and others have decided to apply 0% capital requirements to mortgage acquisitions, in sharp contrast to the full capital requirements applicable to users of advances.

While it is difficult to see the public policy benefits to be derived from the System's foray into the secondary mortgage market, it is very easy to see the significant risks. If left unchecked, this current expansion will likely increase the overall amount of GSE activity in the secondary mortgage market, and thus taxpayer exposure, while injecting new operational and credit risks as the System seeks to establish market share.

If the System does stumble, it is doubtful that Congress will be of a mind once again to resurrect it. More likely, it will simply be the end of an institution, which still has vital relevance in its core mission of providing advances to meet the funding needs of member institutions**.** Hopefully, Congress, the FHFB, or better yet, the System's leadership on its own will reverse these dangerous trends and preserve a System that still has a vital role in our mortgage finance system.